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C O N F I D E N T I A L CARACAS 000195

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E.O. 12958: DECL: 01/20/2015
TAGS: ECON PGOV EFIN ENRG VE
SUBJECT: HOW LOW MUST IT GO? OIL REVENUES AND CHAVEZ'S ABILITY TO KEEP SPENDING

REF: 04 CARACAS 3331

Classified By: Economic Counselor Richard M. Sanders. Reason: 1.4(b) and (d).

Summary

¶1. (C) Key to President Chavez's political success thus far has been his expansive fiscal policy, in which large sums, only partially accounted for in budgeting procedures, are provided to pay for popular social "missions" in education, health care, and job creation, and for (promised) big-ticket infrastructure projects. The revenues from continued high oil prices have bankrolled this winning strategy thus far. But, as some basic number crunching can tell us, significant declines in price rapidly translate into less money available for government spending. However, the GOV has its options to deal with such a crisis) squeezing more money from the oil sector, borrowing more both internally and externally, and in a pinch, diverting investment spending into social welfare consumption and printing more local currency (albeit at a cost in inflation). We expect that Chavez would try all such measures before accepting the pain of spending cuts ahead of the December 2006 Presidential election. End summary.

Spend It While You've Got It

¶2. (C) The official Venezuelan budget for CY 2005 plans for expenditures of 69.3 trillion bolivars (USD 32.2 billion at the projected official exchange rate of 2150 bolivars per dollar, reftel). The budget dedicates 40.5 pct of spending to "priority nature" social areas, specifically mentioning the "Mision Ribas" and "Mision Sucre" high school and college scholarship programs, the "Barrio Adentro" program of installing Cuban doctors in poor neighborhoods, and the "Mercal" chain of stores selling staple foodstuffs at discounted prices. This budget, however, in no way can be considered a definitive statement of GOV spending plans. Historically, supplemental appropriations have topped off the budget, a practice continued by the Chavez government. We note that while the 2004 budget called for spending of 50 trillion bolivars (USD 26.0 billion at the current exchange rate of 1920 bolivars per dollar), but ended up at 57 trillion bolivars (29.7 billion) a 14 pct increase.

¶3. (C) Estimations of the GOV's likely expenditures for 2005 are complicated by extensive off-budget spending, for which little accounting is made. In mid-2004, the GOV announced that state oil company PDVSA would provide USD 1.7 billion for a "social investment fund" which we understand to largely be support for the various "missions" and also for housing construction. We are unable to say how much has been spent in 2004 and how much remains available for 2005 and whether PDVSA will be required to make a second similar contribution once the first one is completely spent down. (We expect it will be.)

¶4. (C) PDVSA was also tapped in 2004 for a USD 2 billion "special development fund" to be used for big-ticket infrastructure projects, such as additions to the Caracas metro, rural roads, and an additional bridge over the Orinoco River. Our understanding is that much of this USD 2 billion has been allocated for specific projects, although not yet spent. Press reports indicate the Chavez is insisting that the fund is "revolving" and that PDVSA will need to replenish it as it is spent down.

¶5. (C) The labyrinth of GOV public finance is such that, for example, when Chavez announced recently that he would spend USD 1 billion on housing in 2005, it was unclear how much would come from the regular budget, how much from

off-budget PDVSA sources, and how much was mere puffery. We also note a somewhat mysterious announcement in the Gaceta Oficial (Federal Register-equivalent), listing a vast array of projects, ranging from irrigation networks to air traffic control systems and military helicopters for which various ministries would be allowed to enter into indebtedness in ¶2005. Whether all these items will be purchased in 2005 and whether they will be scored against the budget remains unclear. However, assuming that, as in 2004, there will be supplemental appropriations amounting to 14 pct of the original submission, and that despite some effort to put more of it on budget, a large amount of social and infrastructure spending will come off-budget directly from PDVSA, we estimate that the GOV looks to spend as much as USD 38 billion in 2005.

How Oil Money Comes In

¶6. (C) According to the GOV's budget submission, oil income represents 37.1 pct of the revenue for the budget, tax revenues, (principally VAT) represent 36.7 pct of revenue, borrowing (both internal and external) represents 21.3 pct, and "extraordinary income" (additional bolivars obtained by the Central Bank as a result of devaluation) represents 4.9 pct. This, of course, does not include the off-budget PDVSA social spending programs mentioned above, nor the funding which will be needed to cover the additional supplemental appropriations which can be expected. Oil revenue comes in three forms:

¶7. (C) The first is a per barrel royalty on production. Oil produced by PDVSA itself or by foreign oil companies under "operating agreements" is subject to a 30 pct royalty. Orinoco heavy crudes produced by international oil companies in "strategic associations" with PDVSA were initially subject to a mere one pct royalty for a ten year period as an incentive to invest in these technically challenging areas. In October 2004, the GOV raised the royalty to 16.67 pct without consultation with the companies. Using a very conservative oil price assumption of USD 23.00 per barrel for the "Venezuelan basket" of crudes, which generally trades at 8-9 dollars below the price of West Texas Intermediate, but a grossly inflated assumption of oil production of 3.39 million barrels per day, the GOV estimates it will earn USD 7.44 billion in royalties. (A more realistic figure would be between 2.6 and 2.7 million barrels per day, see below, para 10 for the revenue this would generate.)

¶8. (C) The second source of revenue for the GOV from oil is the 50 pct income tax paid by PDVSA on oil earnings and a 30 pct income tax paid by private companies. (The tax is charged further down the chain of production, resulting in considerable deduction for expenses, and hence produces less revenue than do royalties.) We understand that the Orinoco heavy crude "strategic associations" pay relatively little income tax, as they are still able to deduct for the enormous expenses involved in starting up these projects. The GOV estimates that it will receive USD 1.78 billion in 2005 from this source.

¶9. (C) There are two other ways in which the GOV has additional access to oil revenue. PDVSA annually pays a dividend to its sole stockholder, the GOV. This is a major matter for high-level negotiation between the two, as the higher the dividend paid, the less is available for capital investment (and hence the maintenance of production). In the budget, the GOV anticipates getting a dividend of USD 1.34 billion. And as mentioned above, PDVSA has been committed to a USD 2 billion revolving infrastructure development fund and a USD 1.7 billion social fund. (We are told that a likely reason for the creation of these funds, as opposed to simply increasing PDVSA's dividend last year was to enable the GOV to avoid splitting the money with state governments as would be required under the revenue sharing provisions of the Venezuelan constitution.)

Scenarios) Rosy and Dark

¶10. (C) Thus under the GOV's 2005 budget oil income produces USD 10.56 billion in revenue (plus several billion more which we can expect from off-budget contributions from PDVSA). This is a major contribution towards the very large USD 38 billion in actual spending which we suspect the GOV is looking at for 2005. If we plug more in a more realistic (higher) oil price of 34 dollars per barrel and a more realistic (lower) oil production figure of 2.67 million barrels per day (1.90 million for PDVSA's own production plus operating agreements and 727,000 for the heavy crude strategic associations), we get a similar, if a bit higher figure of USD 10.79 billion in oil income. This leads us to suspect that the oil price assumption is being low-balled to

allow the GOV to maintain the fiction that oil production has completely recovered from the December 2002-February 2003 general strike. In our view, among these earnings, tax revenues and both internal and external borrowing, the GOV should be able to fulfill its ambitious spending plans for 2005 and 2006 under this scenario.

¶11. (C) But what if oil prices start to decline? If the average price for the year for Venezuelan oil dropped from USD 34 dollars per barrel to USD 30 per barrel the lower take from royalties would mean that annual GOV petroleum income drops to USD 9.67 billion, a loss of USD 1.12 billion. (This does not include any drop in income tax earnings as well). If oil prices drop to USD 25 per barrel for the year, the loss in royalties takes income down to USD 8.28 billion, a loss of USD 2.51 billion; and if there were a very sharp drop in prices, down to USD 20 per barrel, royalty income would drop to USD 6.89 billion, a loss of USD 3.89 billion. Assuming total spending at USD 38 billion, the USD 30 per barrel price creates a revenue gap of 2.9 pct of planned spending, the USD 25 per barrel price one of 6.6 pct of planned spending, and the USD 20 per barrel price one of 10.2 pct.

First Choice -- Look for More Oil Revenue

¶12. (C) Scenarios of prolonged oil price decline would be unpalatable for the GOV. If it were to seek to close the revenue gap that a price decline would entail, the orthodox approach would be to, first consolidate its budget, bringing in the massive unaccountable PDVSA-financed social welfare and infrastructure expenditures onto its books, and then to start to seriously rein in discretionary spending and perhaps raise taxes. However, we can predict with confidence that this is precisely what it will not do, at least through to the December 2006 Presidential elections, given that this spending is generally regarded as having been crucial to Chavez's success in defeating the opposition in the August 15 recall referendum and securing his position as the perceived benefactor of the 70 pct of Venezuelans who live below the poverty line.

¶13. (C) The GOV also has a full range of options at its disposal to try and deal with the revenue shortfalls that these scenarios present. The first would be to increase revenue. If PDVSA's own production were to rise by an additional 150,000 barrels per day, this would create an additional USD 821 million in annual income at an oil price of USD 30 per barrel. (The benefit obviously drops if the price goes down, to USD 684 million at USD 25 per barrel and USD 547 million at USD 20 per barrel.) But ramping up production, in addition to taking time (a major improvement might not be seen until the end of 2005 even if work is starting now), would not be a cost-free exercise as it would require investment in new drilling, etc. that would require funds which otherwise could be directly diverted to social/electoral spending. However, some industry observers have suggested that the first signs of an increase are visible. Of course, the GOV could also go in the exactly opposite direction, slashing PDVSA investment and increasing its dividend requirement. This could provide ready cash, perhaps as much as USD 1 billion more, but at a price of far lower revenue further down the line. But if it could be convinced that the pain will not be felt until after the December 2006 elections, the Chavez government could well adopt this approach.

¶14. (C) If the GOV is looking for a quick revenue hit, it could repeat its performance of October 2004, when it unilaterally raised royalties paid by international oil companies on their Orinoco heavy crude operations from 1.0 pct to 16.67 pct. If it were to further raise the royalty to 30 pct (as some industry figures have suggested it might), this would generate an additional USD 1.06 billion per year at an oil price of USD 30 albeit at the cost of further strain in its relations with the international oil companies, and probably lessened investment over the longer term. At a price of USD 25 per barrel, this move would generate USD 885 million, and at 20 dollars per barrel would generate USD 708 million.

And Borrow More

¶15. (C) There is probably more room for the GOV to borrow both externally and internally as part of a strategy to keep spending up in the face of reduced oil revenue. Venezuela's debt to GDP ratio has risen under the free-spending Chavez government, from 27 pct in 2001 to 40 pct in 2004, but this nonetheless remains a relatively low base. And in terms of

debt management, the Finance Ministry has (as even political opponents of the Chavez government will admit) done a good job of undertaking operations to push maturities back and obtain more favorable yields on its foreign debt. Venezuela country risk is high enough at over 460 base points to command attractive premiums on instruments the GOV might offer, while the perceived steady flow of oil revenue, together with the fact that in the worst moment, the December 2002-February 2003 general strike, the GOV did not default, has left Venezuela with a positive impression in markets. It is possible that if overall conditions remain favorable for emerging market debt that the GOV could opportunistically issue several hundred million in bonds, even if oil dropped to USD 30 per barrel for an extended time. Market appetite for Venezuelan debt might however be considerably smaller at USD 25 or USD 20 per barrel.

¶16. (C) The GOV could also look to further internal borrowing, taking advantage of exchange controls which give banks few alternative investment opportunities. Extensive internal borrowing is already programmed into GOV planning, but the GOV may be willing to increase it significantly to address an oil price shock despite the crowding out of lending to productive investment (now only beginning to recover) as well as the systemic damage it would do to Venezuela's banking sector.

Less Palatable Options

¶17. (C) While the best alternative to deal with a price shock from the GOV's point of view might be to squeeze the petroleum sector or hit up lenders for some more cash (and this may be enough to get through a drop to USD 30 per barrel), it has a number of other options available before it has to slice into its social spending. One likely choice is cutting back on investment: As noted above, the GOV has big plans for infrastructure spending from PDVSA's USD 2 billion off-budget "special development fund." While most of the money currently designated for the fund has been allocated, it has not actually been spent. The GOV could slow spending down or cut out some of projects, and divert the savings to supporting the "missions." The downside is that these projects have been highly touted and have in many cases strong local constituencies among governors (almost all of whom are now pro-Chavez). And, of course, the employment generation that construction projects create would be lost. But as one banker told us, "sacrificing investment for consumption is what Venezuelan governments have always done. Why should Chavez be different?"

¶18. (C) The other traditional recourse of governments in financial trouble is to expand the money supply and with it, devalue the bolivar so that local more currency obligations can be paid off with fewer dollars. There are signs that the GOV very much wants to have this option available. It has embarked upon a systematic campaign to undo the independence of the Central Bank, encouraging retirements by long-term career staff, and has publicly browbeaten Bank leadership into letting PDVSA create its special development fund instead of passing all its earnings through the Bank. Chavez has just named hard-core loyalist Gaston Parra as the new Bank President. And he has constantly pressed the Bank to recalculate upward the amount of local currency gains obtained as a result of previous devaluations of the bolivar that can be transferred to the GOV. The introduction of large amounts of excess liquidity into the financial system that this implies is, of course, a recipe for inflation. One leading economist suggested to us that the GOV's strategy will be to, when necessary (1) tighten exchange controls to prevent capital flight, and (2) use price controls and its ramshackle social welfare network, especially the Mercal discount food store chain, to shield the poor from the worst of inflation, while letting it fall fully on the backs of the middle and upper classes. In looking at any devaluation scenario, we must remember the remarkably high (USD 23 billion) level of international reserves the Central Bank has, as a result of oil revenues. The process of expanding the money supply could continue for a fairly long period before the negative effects were felt.

Comment: Facing A Potential Storm

¶19. (C) As of now, the Venezuelan basket of crudes stands at a healthy USD 36 per barrel, and none of these scenarios of price decline may yet do more than trouble Chavez' dreams. But even if they do come to pass, at an average price of USD 30 per barrel, even for two years, the GOV can probably slide by, scaring up money from lenders and (more reluctantly) oil companies. At USD 25 per barrel, the policy mix will be more painful, with major cuts in investment required to sustain

current spending, especially the social welfare missions. Some measure of inflation will probably also be needed to cover the gap. But Chavez will probably still be able to make it to the December 2006 presidential election with the basic model of the Bolivarian benefactor state intact. At USD 20 per barrel, he will probably have to cut back far, just about abandoning all investment spending and letting inflation rip. Some of the less critical "mission" programs, such as the one to stimulate housing will probably have to be suspended. The Mercal subsidized food program, which will be especially crucial if inflation takes off and the "Barrio Adentro" program of Cuban doctors in poor neighborhood, both of which are regarded as extremely popular, would likely be the last to go.
McFarland

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